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HOUSE OF REPRESENTATIVES

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February 12, 2007

Honorable Chester J. Culver  
Governor  
State Capitol Building  
Des Moines, IA 50319

Dear Governor Culver:

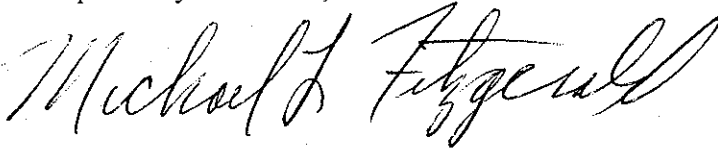
Per Iowa Code 12E.15, the Tobacco Settlement Authority (the "TSA") is required to file an annual report regarding its activities for the previous fiscal year. I have enclosed the TSA's financial statements and independent auditors' report for fiscal year ending June 30, 2006. Please note that we are forwarding this information to you promptly after our receipt of the audit report on February 7, 2007.

Due to low interest rates and the re-emergence of the market for tobacco bonds, in July 2005 the TSA began analyzing the financial feasibility of restructuring and/or extending the final maturity of the Tobacco Settlement Authority Asset-Backed bonds. Alternative structures were analyzed by the financing team and refined based on market conditions and legal considerations. Based on this analysis, a plan of finance was presented to the TSA board at the November 2005 board meeting. On November 9, 2005 the TSA adopted a resolution to proceed with a tobacco securitization based on a turbo amortization structure.

The Tobacco Settlement Authority Series 2005 Bonds priced on November 17, 2005 and closed on November 30, 2005. This issuance provided \$100.4 million in tax-exempt proceeds and \$50.1 million in taxable proceeds. The pledged Tobacco Settlement Revenues ("TSRs") remained at 78% with the remaining 22% continuing to flow into the Endowment for Iowans' Health Fund. The stated maturity of the bonds is 2046 with an expected maturity of 2028. The turbo structure that was utilized in this transaction provided the most effective opportunity to transfer additional tobacco industry risk and provide additional funds for the State.

As allowed under the Master Settlement Agreement reached in 1998 between states and tobacco companies, approximately \$6.6 million of the TSR's due to the State of Iowa in FY06 were withheld and placed in a disputed payment account. Iowa's attorney general has filed a motion seeking recovery of this money, plus interest. It is likely that money will also be withheld from the TSR's expected in April 2007 because the dispute over the withholding has not been settled. This would result in lower-than-expected revenues for the Endowment for Iowans' Health Fund and lower-than-expected turbo redemptions of the 2005 bonds in FY07.

Respectfully submitted,

A handwritten signature in cursive script, reading "Michael L. Fitzgerald". The signature is written in dark ink and is positioned above the printed name and title.

Michael L. Fitzgerald  
Tobacco Settlement Authority, Chairperson

enc: Tobacco Settlement Authority FY06 Audited financial statements

cc: Honorable Thomas Miller, Attorney General  
Senator John P. Kibbie, President of the Senate  
Representative Patrick Murphy, Speaker of the House  
Mike Marshall, Secretary of the Senate  
Mark Brandsgard, Chief Clerk of the House ✓  
David A. Vaudt, Auditor of State  
Charles Krogmeier, Director, Department of Management



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HOUSE OF REPRESENTATIVES

**TOBACCO SETTLEMENT AUTHORITY**  
(A Component Unit of the State of Iowa)

Basic Financial Statements

June 30, 2006 and 2005

(With Independent Auditors' Report Thereon)

**TOBACCO SETTLEMENT AUTHORITY**  
(A Component Unit of the State of Iowa)

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KPMG LLP  
2500 Ruan Center  
666 Grand Avenue  
Des Moines, IA 50309

## Independent Auditors' Report

The Board  
Tobacco Settlement Authority:

We have audited the accompanying financial statements of the Tobacco Settlement Authority (the Authority), a component unit of the State of Iowa, as of and for the years ended June 30, 2006 and 2005, as listed in the table of contents. These financial statements are the responsibility of the Authority's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Authority's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Tobacco Settlement Authority as of June 30, 2006 and 2005, and the respective changes in financial position and cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated January 23, 2007 on our consideration of the Authority's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.



The management's discussion and analysis on pages 3 through 6 is not a required part of the basic financial statements but is supplementary information required by U.S. generally accepted accounting principles. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

KPMG LLP

January 23, 2007

**TOBACCO SETTLEMENT AUTHORITY**  
(A Component Unit of the State of Iowa)

**Management's Discussion and Analysis**

June 30, 2006 and 2005

The Tobacco Settlement Authority (Authority) provides this management's discussion and analysis of the Authority's annual financial statements. This narrative overview and analysis of the financial activities of the Authority is for the fiscal years ended June 30, 2006 and 2005. We encourage readers to consider this information in conjunction with the Authority's basic financial statements, which follow this section.

**Using These Financial Statements**

This discussion and analysis is intended to serve as an introduction to the Authority's basic financial statements, which consist of the statements of net assets (deficit), the statements of revenues, expenses, and changes in net assets (deficit), and the statements of cash flows (pages 7 through 9). These basic financial statements provide information about the activities of the Authority as a whole and include all assets and liabilities using the accrual basis of accounting, which is similar to the accounting used by most private-sector companies. They also include the notes to the financial statements, which explain some of the information in the basic financial statements in greater detail and are further described as follows:

***The Statements of Net Assets (Deficit)***

The statements of net assets (deficit) present all of the Authority's assets and liabilities, with the differences between the two reported as "net assets (deficit)". Over time, increases or decreases in the Authority's net assets may serve as a useful indicator of whether the financial position of the Authority is improving or deteriorating.

***The Statements of Revenues, Expenses, and Changes in Net Assets (Deficit)***

The statements of revenues, expenses, and changes in net assets (deficit) present information showing how the Authority's net assets (deficit) changed during the most recent fiscal year. All changes in net assets (deficit) are reported as soon as the event or change occurs, regardless of the timing of related cash flows. Thus, revenues and expenses are reported in these statements for some items that will not result in cash flows until future fiscal periods.

***The Statements of Cash Flows***

The statements of cash flows report the net increase (or decrease) in cash and cash equivalents (highly liquid investments with a maturity of three months or less when purchased) for the fiscal year. These statements include cash flows from operating activities, cash flows from non-capital financing activities (such as issuance of or payments on bonds), and cash flows from investing activities. The resulting net increase (or decrease) in cash and cash equivalents is then added to the balance of cash and cash equivalents at the beginning of the year to determine the FY06 and FY05 ending cash and cash equivalents balance.

***Notes to the Financial Statements***

The notes provide additional information that is essential to a full understanding of the data provided in the basic financial statements. The notes to the financial statements can be found beginning on page 10.

**Financial Analysis of the Authority**

In 2001, the Authority sold approximately \$644 million of bonds at a discount providing approximately \$630 million in proceeds. After paying for costs of issuance and establishing reserve funds as required by the bond indenture, approximately \$579 million was distributed to the State. In return for the distribution, the

**TOBACCO SETTLEMENT AUTHORITY**  
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Management's Discussion and Analysis

June 30, 2006 and 2005

Authority received 78% of the payments the State received under the Master Settlement Agreement signed in 1998 between 46 states and four major tobacco industry manufacturers to be used to repay the bonds issued. In November 2005, the Authority issued approximately \$832 million of Tobacco Settlement Asset-Backed Bonds. The proceeds from the Series 2005 bonds were used to refund the Series 2001 bonds, fund a debt service reserve account, pay costs of issuance, and provide approximately \$151 million to the State. The Authority continues to receive 78% of Iowa's tobacco settlement revenues to fund debt service.

The Authority's financial activity resulted in negative net assets of approximately \$676 million and \$525 million at June 30, 2006 and 2005, respectively. The negative net assets result from the Authority recording a liability, in accordance with U.S. generally accepted accounting principles, for the entire amount of outstanding bonds. Further, the same accounting principles preclude the State from recording anticipated receipts of anticipated proceeds from the Master Settlement Agreement. The holders of the Authority's bonds demonstrated their belief that those proceeds will be realized by the Authority and will be used to repay the bonds. If the Authority does not realize sufficient proceeds, not all bonds will be repaid.



# TOBACCO SETTLEMENT AUTHORITY

(A Component Unit of the State of Iowa)

## Management's Discussion and Analysis

June 30, 2006 and 2005

Condensed financial information as of and for the years ended June 30, 2006, 2005, and 2004 is as follows:

	<u>2006</u>	<u>2005</u>	<u>2004</u>
<b>Assets:</b>			
Current assets	\$ 21,836,418	18,281,718	17,496,384
Noncurrent assets	81,450,964	87,545,798	78,724,440
Total assets	<u>103,287,382</u>	<u>105,827,516</u>	<u>96,220,824</u>
Current liabilities	17,703,845	4,231,854	3,681,294
Noncurrent liabilities	<u>761,662,078</u>	<u>626,689,120</u>	<u>627,899,434</u>
Total liabilities	<u>779,365,923</u>	<u>630,920,974</u>	<u>631,580,728</u>
Net assets (deficit)	<u>\$ (676,078,541)</u>	<u>(525,093,458)</u>	<u>(535,359,904)</u>
<b>Operating revenues:</b>			
Tobacco settlement revenues	\$ 40,154,165	44,011,224	38,642,388
Miscellaneous income	<u>281,159</u>	<u>—</u>	<u>—</u>
Total operating revenues	<u>40,435,324</u>	<u>44,011,224</u>	<u>38,642,388</u>
<b>Operating expenses:</b>			
Operating expenses	60,260	54,181	106,656
Enforcement expenses	<u>519,491</u>	<u>315,433</u>	<u>305,535</u>
Total operating expenses	<u>579,751</u>	<u>369,614</u>	<u>412,191</u>
Operating income	39,855,573	43,641,610	38,230,197
Nonoperating expenses, net	<u>(190,840,656)</u>	<u>(33,375,164)</u>	<u>(33,807,690)</u>
Change in net assets (deficit)	<u>(150,985,083)</u>	<u>10,266,446</u>	<u>4,422,507</u>
Net assets (deficit) beginning of year	<u>(525,093,458)</u>	<u>(535,359,904)</u>	<u>(539,782,411)</u>
Net assets (deficit) end of year	<u>\$ (676,078,541)</u>	<u>(525,093,458)</u>	<u>(535,359,904)</u>

### **Net Assets**

The Authority's net assets decreased approximately \$151 million during fiscal year 2006 due to the bond issuance and related transfer to the State.

The Authority's net assets increased approximately \$10.3 million during fiscal year 2005 due to the following:

- (a) Cash and investments increased \$8.8 million due largely to the Authority holding tobacco settlement collections in the Trapping Account as required by the bond indenture. In addition, higher balances also generated more interest income that increased net assets.
- (b) Liabilities of the Authority decreased slightly because of principal bond payments.

## **TOBACCO SETTLEMENT AUTHORITY**

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### **Management's Discussion and Analysis**

June 30, 2006 and 2005

#### ***Long-Term Debt***

At June 30, 2006 and 2005, the Authority had \$775,785,321 and \$627,899,434, respectively, in tobacco settlement asset-backed bonds outstanding. More detailed information about the Authority's debt is presented in note 3 to the financial statements.

#### ***Known Facts***

Each pack of cigarettes sold in Iowa is levied with a \$.36 state tax and a \$.39 federal tax, totaling \$.75 per pack. Iowa's \$.36 tax rate is the 42<sup>nd</sup> highest in the nation and falls significantly below the national average of \$1.00 per pack. Iowa last increased the state's tax on cigarettes June 1, 1991. Since January 1, 2002, 42 states have implemented or passed higher cigarette tax rates.

The Authority has covenanted to apply all surplus collections, if any, to the turbo redemption of Series 2005 bonds. Turbo redemptions paid during the fiscal year totaled \$2,555,000.

#### **Contacting the Tobacco Settlement Authority Financial Management**

This financial report is designed to present users with a general overview of the Authority's finances and to demonstrate the Authority's accountability for the funds generated. If you have any questions about the report or need additional financial information, please contact the Office of the State Treasurer, State Capitol Building, Des Moines, IA 50319.

**TOBACCO SETTLEMENT AUTHORITY**  
(A Component Unit of the State of Iowa)

Statements of Net Assets (Deficit)

June 30, 2006 and 2005

<b>Assets</b>	<b>2006</b>	<b>2005</b>
Current assets:		
Cash on deposit with Treasurer of State	\$ 3,381,097	167,472
Accounts receivable	4,500	188,953
Master settlement agreement receivable	17,859,536	17,392,469
Interest receivable	424,662	465,637
Deferred charges	166,623	67,187
Total current assets	21,836,418	18,281,718
Noncurrent assets:		
Restricted assets:		
Cash and cash equivalents	281,307	66,745
Investments	77,837,189	86,113,286
Deferred charges	3,332,468	1,365,767
Total assets	103,287,382	105,827,516
<b>Liabilities</b>		
Current liabilities:		
Accounts payable	144,819	189,263
Deferred revenue	343,177	—
Bonds payable, current portion	14,123,243	1,210,314
Accrued interest payable	3,092,606	2,832,277
Total current liabilities	17,703,845	4,231,854
Noncurrent liabilities:		
Bonds payable, net of current portion	761,662,078	626,689,120
Total liabilities	779,365,923	630,920,974
Net assets (deficit)	\$ (676,078,541)	(525,093,458)

See accompanying notes to financial statements.

**TOBACCO SETTLEMENT AUTHORITY**  
(A Component Unit of the State of Iowa)

Statements of Revenues, Expenses, and Changes in Net Assets (Deficit)

Years ended June 30, 2006 and 2005

	<u>2006</u>	<u>2005</u>
Operating revenues:		
Tobacco settlement revenues	\$ 40,154,165	44,011,224
Miscellaneous income	281,159	—
Total operating revenues	<u>40,435,324</u>	<u>44,011,224</u>
Operating expenses:		
Operating expenses	60,260	54,181
Enforcement expenses	519,491	315,433
Total operating expenses	<u>579,751</u>	<u>369,614</u>
Operating income	<u>39,855,573</u>	<u>43,641,610</u>
Nonoperating revenues (expenses):		
Transfers to the State of Iowa	(151,363,457)	—
Interest income	4,788,788	3,177,167
Amortization of bond issuance costs	(83,312)	(67,187)
Interest expense	(44,182,675)	(36,485,144)
Total nonoperating expenses, net	<u>(190,840,656)</u>	<u>(33,375,164)</u>
Change in net assets (deficit)	<u>(150,985,083)</u>	<u>10,266,446</u>
Net assets (deficit) beginning of year	<u>(525,093,458)</u>	<u>(535,359,904)</u>
Net assets (deficit) end of year	<u>\$ (676,078,541)</u>	<u>(525,093,458)</u>

See accompanying notes to financial statements.

**TOBACCO SETTLEMENT AUTHORITY**  
(A Component Unit of the State of Iowa)

Statements of Cash Flows

Years ended June 30, 2006 and 2005

	<u>2006</u>	<u>2005</u>
Cash flows from operating activities:		
Cash received from tobacco settlement agreement	\$ 39,687,098	43,292,249
Miscellaneous receipts	808,789	—
Cash payments to suppliers	(624,195)	(373,383)
Net cash provided by operating activities	<u>39,871,692</u>	<u>42,918,866</u>
Cash flows from noncapital financing activities:		
Transfers to the State of Iowa	(151,363,457)	—
Proceeds from issuance of bonds	809,880,632	—
Principal payment on bonds	(669,399,892)	(1,490,000)
Payment of interest on bonds	(36,517,199)	(35,651,129)
Payment of bond issuance costs	(2,149,449)	—
Net cash used in noncapital financing activities	<u>(49,549,365)</u>	<u>(37,141,129)</u>
Cash flows from investing activities:		
Purchases of investments	(254,223,409)	(186,055,309)
Sale/maturities of investments	262,499,506	175,826,437
Interest received on investments	4,829,763	3,019,107
Net cash provided by (used in) investing activities	<u>13,105,860</u>	<u>(7,209,765)</u>
Increase (decrease) in cash and cash equivalents	3,428,187	(1,432,028)
Cash and cash equivalents, beginning of year	<u>234,217</u>	<u>1,666,245</u>
Cash and cash equivalents, end of year	\$ <u><u>3,662,404</u></u>	<u><u>234,217</u></u>
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ 39,855,573	43,641,610
Adjustments to reconcile operating income to net cash provided by operating activities:		
Increase in receivables	(282,614)	(718,975)
Decrease in payables	(44,444)	(3,769)
Increase in deferred revenue	343,177	—
Net cash provided by operating activities	<u><u>\$ 39,871,692</u></u>	<u><u>42,918,866</u></u>

See accompanying notes to financial statements.

# **TOBACCO SETTLEMENT AUTHORITY**

(A Component Unit of the State of Iowa)

## **Notes to Financial Statements**

June 30, 2006 and 2005

### **(1) Summary of Significant Accounting Policies and Related Matters**

#### **(a) Organization**

The Tobacco Settlement Authority (the Authority) was authorized by the provisions of Chapter 12E of the Code of Iowa on May 19, 2000. The purposes of the Authority include: (a) to implement and administer a program plan and to establish a stable source of revenue to be used for purposes designated in Chapter 12.65 of the Code of Iowa, (b) to enter into sales agreements, (c) to issue bonds and enter into funding options including refunding and refinancing its debt and obligations, (d) to sell, pledge, or assign, as security, all or a portion of the State's share, to provide for and secure the issuance of its bonds, (e) to invest funds available to provide for a source of revenue in accordance with the program plan, (f) to enter into agreements with the State for the periodic distribution of amounts due the State under any sales agreement, (g) to refund and refinance the Authority's debts and obligations, and to manage its funds, obligations, and investments as necessary, (h) to sell, pledge, or assign, as security or consideration, all or a portion of the State's share to implement alternative funding options, and (i) to implement the purposes of Chapter 12E of the Code of Iowa.

#### **(b) Reporting Entity**

The Authority is a component unit of the State of Iowa (State). The financial statements of the Authority are included in the State's comprehensive annual financial report.

For financial reporting purposes, the Authority has included all funds, organizations, agencies, boards, commissions, and authorities. The Authority has also considered all potential component units for which it is financially accountable, and other organizations for which the nature and significance of their relationship with the Authority are such that exclusion would cause the Authority's financial statements to be misleading or incomplete. The Governmental Accounting Standards Board (GASB) has set forth criteria to be considered in determining financial accountability. These criteria include appointing a voting majority of an organization's governing body, and (1) the ability of the Authority to impose its will on that organization or (2) the potential for the organization to provide specific benefits to, or impose specific financial burdens on the Authority. The Authority has no component units which meet the GASB criteria.

#### **(c) Measurement Focus, Basis of Accounting, and Financial Statement Presentation**

The Authority is accounted for using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows.

In reporting the financial activity of the Authority, the Authority applies all applicable GASB pronouncements as well as the following pronouncements issued on or before November 30, 1989 unless these pronouncements conflict with or contradict GASB pronouncements: Financial Accounting Standards Board Statements and Interpretations, Accounting Principles Board Opinions, and Accounting Research Bulletins of the Committee on Accounting Procedure.

## **TOBACCO SETTLEMENT AUTHORITY**

(A Component Unit of the State of Iowa)

### **Notes to Financial Statements**

June 30, 2006 and 2005

For financial statement purposes, the Authority is treated as an enterprise fund, a proprietary fund type. Proprietary funds distinguish operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with a proprietary fund's principal ongoing operations, which includes the monetization of the State's future tobacco settlement payments. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

The Authority's board consists of the Treasurer of State, Auditor of State, and the Director of the Department of Management of the State.

#### **(d) Master Settlement Agreement**

On November 23, 1998, a Master Settlement Agreement (MSA) was entered into between forty-six states (including the state of Iowa) and the four major tobacco industry manufacturers. The MSA represents the resolution of a large potential financial liability of the tobacco industry manufacturers for smoking-related injuries. The forty-six states agreed to settle all past, present, and future smoking-related claims against the tobacco industry manufacturers in exchange for agreements and undertakings by the tobacco industry manufacturers concerning a number of issues.

The MSA sets forth the schedule and calculation of payments to be made by the tobacco industry manufacturers to the states. These payments are subject to various adjustments and offsets. Payments to be received under the MSA include:

- a. five initial payments, the last of which was paid in January 2003;
- b. annual payments which are required to be made on April 15 of each year and will continue in perpetuity; and
- c. ten strategic contribution fund payments which are required to be made annually on April 15 beginning April 15, 2008 through April 15, 2017.

#### **(e) Program Plan**

Chapter 12E.10 of the Code of Iowa directs the Authority to establish a Tobacco Settlement Program Plan (Program Plan) to provide the State with a secure and stable source of revenue for the purposes designated in Chapter 12.65 of the Code of Iowa. These purposes relate to healthcare, substance abuse treatment and enforcement, tobacco use prevention and control, and other purposes related to the needs of children, adults, and families in the State and to create a savings account for healthy Iowans invested to provide an ongoing source of investment earnings.

The Program Plan was submitted to the Legislative and Executive Council of the State. Implementation of the Program Plan was authorized by a constitutional majority of each house of the General Assembly and approved by the Governor of the State.

**TOBACCO SETTLEMENT AUTHORITY**  
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Notes to Financial Statements

June 30, 2006 and 2005

**(f) Sales Agreement**

Upon approval of the Program Plan, the State and the Authority entered into a sales agreement in which the State agreed to sell to the Authority all of its right, title, and interest in certain amounts payable to the State under the MSA. In return, the Authority agreed to issue tobacco settlement bonds and remit the net bond proceeds to the State.

**(g) Tobacco Settlement Asset-Backed Bonds, Series 2001**

The Authority issued Tobacco Settlement Asset-Backed Bonds, Series 2001 (Series 2001 Bonds), dated October 25, 2001, in the amount of \$644,245,000. The Series 2001 Bonds were advance refunded from the proceeds of the Tobacco Settlement Asset-Backed Bonds, Series 2005 issued November 30, 2005.

**(h) Tobacco Settlement Asset-Backed Refunding Bonds, Series 2005**

The Authority issued Tobacco Settlement Asset-Backed Bonds, Series 2005 (Series 2005 Bonds), dated November 30, 2005, in the amount of \$831,962,030. The Series 2005 Bonds are special revenue obligations of the Authority secured by, and payable solely and only out of, the monies, assets or revenues pledged by the Authority pursuant to the indenture, are not a general obligation or general indebtedness of the Authority and do not constitute an obligation or indebtedness of the State or any political subdivision of the State.

The Series 2005 Bonds contain turbo redemption features which require that all tobacco revenue collections in excess of operating expenditures is considered scheduled debt service and should be applied to the redemption of the bonds. The turbo redemptions are not scheduled amortization payments and are to be made only from surplus collections, if any. Failure to make a turbo principal payment will not constitute default.

**(i) Significant Accounting Policies**

The financial statements of the Authority have been prepared in conformity with U.S. generally accepted accounting principles as applied to government units. The more significant of the Authority's accounting policies are described below.

**Cash Equivalents**

For purposes of the statements of cash flows, all highly liquid investments with a maturity of three months or less when purchased are considered to be cash equivalents. Investments not meeting the definition of cash equivalents at June 30, 2006 include corporate notes and a guaranteed investment contract totaling \$77,837,189 and at June 30, 2005 include U.S. Government securities and corporate notes totaling \$86,113,286.

**Investments**

Investments in debt and equity securities are recorded at fair value in the statements of net assets (deficit) with the change in fair value of investments recorded in the statements of revenues,



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Notes to Financial Statements

June 30, 2006 and 2005

expenses, and changes in net assets (deficit). Investment in guaranteed investment contracts are recorded at cost.

**Deferred Charges**

Deferred charges represent bond issuance costs which are deferred and amortized as an adjustment to interest expense over the life of the related bond issue using the straight-line method.

**Bond Discounts and Loss on Refunding**

Bond discounts are deferred and amortized as an adjustment to interest expense over the life of the related bond issue using the effective interest method. The loss on refunding is deferred and amortized over the life of the old bonds using the straight-line method.

**Revenue Recognition**

Future tobacco settlement collections are contingent upon future tobacco products sales subject to various adjustments as outlined in the MSA. The Authority recognizes revenue from tobacco settlement collections as the collections are received by the Authority. In addition, an estimated receivable (Master Settlement Agreement receivable) is accrued at year-end for estimated product sales occurring from January 1 through June 30 of each year.

**Use of Estimates**

Management of the Authority has made a number of estimates and assumptions relating to the reporting of assets, liabilities, revenues, and expenses and the disclosure of contingent assets or liabilities to prepare these financial statements in conformity with U.S. generally accepted accounting principles. Actual results could differ from those estimates.

**(2) Deposits and Investments**

At June 30, 2006 and 2005, the Authority's bank balances of \$0 and \$302 respectively, were covered by federal depository insurance or by the State Sinking Fund in accordance with Chapter 12C of the Code of Iowa. Cash balances of \$3,381,097 and \$167,472, respectively, were held by the State in pooled money funds. Cash equivalents at June 30, 2006 and 2005 included \$281,307 and \$66,443, respectively, invested in open-end mutual funds. Investments are as follows for the year ended June 30, 2006:

Investment type	Fair value/cost	Investment maturities (in years)			Concentration
		Less than 1	1-2	3-5	
Debt securities:					
PB Financial Services Corp.	\$ 18,638,273	18,638,273	—	—	23%
State Treasurer's investment pool	3,381,097	3,381,097	—	—	4
Guaranteed investment contract:					
Security Benefit Life Insurance Co.	59,198,916	—	—	59,198,916	73
	<u>\$ 81,218,286</u>	<u>22,019,370</u>	<u>—</u>	<u>59,198,916</u>	<u>100%</u>

**TOBACCO SETTLEMENT AUTHORITY**  
(A Component Unit of the State of Iowa)

Notes to Financial Statements

June 30, 2006 and 2005

Investments are as follows for the year ended June 30, 2005:

Investment type	Fair value	Investment maturities (in years)			Concentration
		Less than 1	1-2	3-5	
Debt securities:					
Britannia Bldg Society	\$ 2,074,820	2,074,820	—	—	2%
Federal Home Ln Mtg Corp	18,866,080	18,866,080	—	—	22
General Elec CAP Svc	48,135,134	48,135,134	—	—	56
McCormick & Co Inc.	15,698,240	15,698,240	—	—	18
North Sea Fdg Europe	1,339,012	1,339,012	—	—	2
	<u>\$ 86,113,286</u>	<u>86,113,286</u>	<u>—</u>	<u>—</u>	<u>100%</u>

**(a) Interest Rate Risk**

The Authority does not have a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from increasing interest rates.

**(b) Credit Risk**

Under bond resolutions of the Official Statement of the Tobacco Settlement Asset-Backed Bonds, Series 2005, the Authority is authorized to invest in defeasance collateral; noncallable senior debt obligations of U.S. government-sponsored agencies that are not backed by the full faith and credit of the U.S. government; demand and time deposits in or certificates of, or banker's acceptances issued by, any bank or trust company, savings and loan association, or savings bank; municipal obligations of any state of the United States or the State or any political subdivision thereof; commercial or finance company paper; repurchase obligations; securities bearing interest or sold at a discount issued by any corporation incorporated under the laws of the United States or any state, municipality, or political subdivision thereof; units of taxable money market funds; investment agreements, forward delivery agreements, or guaranteed investment contracts rated, or with any financial institution or corporation; other obligations, securities, agreements, or contracts that are noncallable and are acceptable to each nationally recognized rating service agency.

As of June 30, 2006 the Authority's investment in PB Financial Services Corp. commercial paper was rated A1 by Standard & Poor's and P-1 by Moody's Investors Service. The Authority's investment in Security Benefit Life Insurance Co. guaranteed investment contract with a cost of \$59,198,916 is not subject to credit risk categorization.

At June 30, 2005 the Authority's investment in Britannia Bldg. Society and McCormick & Co Inc. commercial paper were rated A1 by Standard & Poor's and P-1 by Moody's Investors Service. The Authority's investment in North Sea Fdg Europe and General Elec Cap Corp, commercial paper were rated A1+ by Standard & Poor's and P-1 by Moody's Investors Service. The Authority's investment in Federal Home Loan Mtg. Corp was rated AAA by Standard & Poor's and Aaa by Moody's Investors Service.

**TOBACCO SETTLEMENT AUTHORITY**  
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**(c) Concentration of Credit Risk**

The Authority places no limit on the amount that may be invested in any one issuer. Concentration percentages by investment type are included in the above table.

**(d) Custodial Credit Risk**

The Authority's deposits in financial institutions were covered by the Federal Deposit Insurance Corporation, or by the State Sinking Fund in accordance with Chapter 12C of the Code of Iowa. The Authority's investments are all held by the State of Iowa or held by the State of Iowa's agent in the name of the Authority.

**(3) Bonds Payable**

The Tobacco Settlement Asset-Backed Bonds were issued in five series: the Series 2005 A Bonds in the principal amount of \$222,910,000, which are federally taxable turbo term bonds, the Series 2005 B Bonds in the principal amount of \$159,368,793, which are federally tax-exempt turbo convertible capital appreciation bonds, the Series 2005 C Bonds in the principal amount of \$412,725,000, which are federally tax-exempt turbo term bonds, the Series 2005 D Bonds in the principal amount of \$15,775,344, which are federally tax-exempt turbo convertible capital appreciation bonds payable only when no current interest bond or convertible capital appreciation bond remains outstanding, and the Series 2005 E Bonds, which are federally tax-exempt turbo convertible capital appreciation bonds, in the principal amount of \$21,182,893, which are federally tax-exempt turbo convertible capital appreciation bonds payable only when no current interest bond, convertible capital appreciation bond, or Series D Bond remains outstanding.

The bonds bear interest at rates of 5.375% to 7.125% and mature in varying annual amounts ranging from \$1,830,000 to \$360,990,000 with the final term and capital appreciation maturities due in the year ending June 30, 2046. The balance outstanding on June 30, 2006 and 2005 was \$775,785,321 (\$1,362,888,000 net of unamortized bond discounts of \$587,094,679) and \$627,899,434 (\$639,460,000 net of unamortized bond discount of \$11,560,566), respectively.

The bond documents include the following provisions:

- (a) The Series 2005 Bonds are special revenue obligations of the Authority secured by, and payable solely and only out of, the monies, assets, or revenues pledged by the Authority pursuant to the Indenture. The bonds are not a general obligation or general indebtedness of the Authority and do not constitute an obligation or indebtedness of the State or any political subdivision of the State. The Authority may not pledge the credit or taxing power of the State or any political subdivision of the State or create a debt or obligation of the State. The Authority has no taxing power. The Series 2005 Bonds constitute neither a general, legal, nor moral obligation of the State or any of its political subdivisions and the State has no obligation or intention to satisfy any deficiency or default of any payment of the bonds.

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- (b) The Series 2005 A, B, and C bonds are secured by and are payable solely from (i) 78% of the future amounts to be received under the MSA, (ii) investment earnings on certain accounts pledged under the bond indenture, (iii) amounts held in the debt service reserve account and the trapping account established under the bond indenture, (iv) amounts held in other accounts established under the bond indenture and (v) certain rights of the Authority as specified in the sales agreement. Subject to the prior payment rights of the Series 2005 A, B, and C bonds, the Series 2005 D and E bonds will be similarly secured and payable from the same sources, except the debt service reserve account, which will not be available as security.
- (c) The Turbo Redemptions of the term bonds represents the requirement to apply 100% of all collections which are in excess of requirements for the funding of operating expenses and the debt service account to the special mandatory par redemption of the Series 2005 Bonds on each distribution date in ascending order of maturity and pro rata within a maturity for the Series 2005 A Bonds and by lot within a maturity for all other Series 2005 Bonds.
- (d) The proceeds of the Series 2005 Bonds, except as deposited in the debt service reserve account, are not pledged to the payment of, and therefore not available to the holders of, the Series 2005 bonds.
- (e) A bond fund is established with the bond indenture trustee, and money will be deposited in the fund as provided in the bond indenture. The money will be held in trust and, except as otherwise provided in the bond indenture, will be applied solely to the payment of debt service. The bond fund includes: the debt service account, the debt service reserve account, the trapping account, the extraordinary prepayment account and such other accounts as deemed necessary.
- (f) The debt service reserve account was funded from bond proceeds in the amount of \$59,198,916. The account will be available to pay (i) the principal and interest on the Series 2005 A, B and C bonds to the extent collections under the MSA are insufficient and (ii) after an event of default, extraordinary prepayments. Amounts in the debt service reserve account will not be available to make (a) turbo redemptions on any bonds or (b) any payment of Series 2005 D or Series 2005 E bonds. Upon the occurrence of an event of default, the outstanding bonds will be prepaid pro rata among all outstanding bonds and other unpaid amounts due on the bonds will be paid from available funds.
- (g) If an event of default has occurred, collections remaining after the payment of certain expenses and all current and past due interest on bonds will be deposited in the extraordinary prepayment account and will be applied, together with amounts in the debt service account, the debt service reserve account, and the extraordinary prepayments account and the partial lump sum payment account, to the extraordinary prepayments of the bonds for principal or, in the case of capital appreciation bonds, the accreted value of outstanding bonds will be paid, in whole or in part, on each succeeding distribution date. The accreted value of capital appreciation bonds and any interest that has accrued will be payable only after all other bonds have been fully paid.

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Annual debt service requirements to maturity for the bonds are as follows:

Year ending June 30,	Series 2005 A Term Bonds (1)			Series 2005 B Convertible Capital Appreciation Bonds (2)		
	SSR	Interest rate	Interest	Principal	Interest rate	Interest
2007	\$ 16,600,000	6.50%	\$ 14,142,537	—	—%	\$ —
2008	20,865,000	6.50	13,244,075	—	5.60	4,984,280
2009	23,190,000	6.50	11,887,850	—	5.60	9,968,560
2010	25,490,000	6.50	10,380,500	—	5.60	9,968,560
2011	28,025,000	6.50	8,723,650	—	5.60	9,968,560
2012 – 2016	106,185,000	6.50	14,849,819	—	5.60	49,842,800
2016 – 2020	—	—	—	—	5.60	49,842,800
2021 – 2025	—	—	—	—	5.60	49,842,800
2026 – 2031	—	—	—	—	5.60	49,842,800
2032 – 2036	—	—	—	178,010,000	5.60	29,074,967
2037 – 2041	—	—	—	—	—	—
2042 – 2046	—	—	—	—	—	—
	<u>\$ 220,355,000</u>		<u>\$ 73,228,431</u>	<u>178,010,000</u>		<u>\$ 263,336,127</u>

Year ending June 30,	Series 2005 C Term Bonds(1)			Series 2005 C Term Bonds(2)		
	SSR	Interest rate	Interest	SSR	Interest rate	Interest
2007	\$ —	5.375%	\$ 5,561,781	—	5.50%	\$ 7,431,600
2008	—	5.375	5,561,781	—	5.50	7,431,600
2009	—	5.375	5,561,781	—	5.50	7,431,600
2010	—	5.375	5,561,781	—	5.50	7,431,600
2011	—	5.375	5,561,781	—	5.50	7,431,600
2012 – 2016	—	5.375	27,808,906	—	5.50	37,158,000
2016 – 2020	—	5.375	27,808,906	—	5.50	37,158,000
2021 – 2025	—	5.375	27,808,906	—	5.50	37,158,000
2026 – 2031	—	5.375	27,808,906	—	5.50	37,158,000
2032 – 2036	—	5.375	27,808,906	—	5.50	37,158,000
2037 – 2041	103,475,000	5.375	10,660,081	—	5.50	37,158,000
2042 – 2046	—	—	—	135,120,000	—	6,812,300
	<u>\$ 103,475,000</u>		<u>\$ 177,513,516</u>	<u>135,120,000</u>		<u>\$ 266,918,300</u>

Year ending June 30,	Series 2005 C Term Bonds(3)			Series 2005 D Capital Appreciation Bonds		
	SSR	Interest rate	Interest	SSR	Interest rate	Interest
2007	\$ —	5.625%	\$ 9,794,812	—	6.25%	\$ —
2008	—	5.625	9,794,812	—	6.25	—
2009	—	5.625	9,794,812	—	6.25	—
2010	—	5.625	9,794,812	—	6.25	—
2011	—	5.625	9,794,812	—	6.25	—
2012 – 2016	—	5.625	48,974,060	—	6.25	—
2016 – 2020	—	5.625	48,974,060	—	6.25	—
2021 – 2025	—	5.625	48,974,060	—	6.25	—
2026 – 2031	—	5.625	48,974,060	—	6.25	—
2032 – 2036	—	5.625	48,974,060	—	6.25	—
2037 – 2041	—	5.625	48,974,060	—	6.25	—
2042 – 2046	174,130,000	5.625	48,157,826	190,800,000	6.25	—
	<u>\$ 174,130,000</u>		<u>\$ 390,976,246</u>	<u>190,800,000</u>		<u>\$ —</u>

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Year ending June 30,	Series 2005 E Capital Appreciation Bonds			Total	
	SSR	Interest rate	Interest	SSR/Principal	Interest
2007	\$ —	7.125%	\$ —	16,600,000	36,930,730
2008	—	7.125	—	20,865,000	41,016,548
2009	—	7.125	—	23,190,000	44,644,603
2010	—	7.125	—	25,490,000	43,137,253
2011	—	7.125	—	28,025,000	41,480,403
2012 – 2016	—	7.125	—	106,185,000	178,633,585
2016 – 2020	—	7.125	—	—	163,783,766
2021 – 2025	—	7.125	—	—	163,783,766
2026 – 2031	—	7.125	—	—	163,783,766
2032 – 2036	—	7.125	—	178,010,000	143,015,933
2037 – 2041	—	7.125	—	103,475,000	96,792,141
2042 – 2046	360,990,000	7.125	—	861,040,000	54,970,126
	<u>\$ 360,990,000</u>		<u>\$ —</u>	<u>1,362,880,000</u>	<u>1,171,972,620</u>

The following summarizes the bond payable activity for the Authority for the years ended June 30, 2006 and 2005:

2006	Beginning balance	Additions	Reductions	Ending balance	Due within one year
Bonds payable:					
Term bonds	\$ 578,150,000	635,635,000	(580,705,000)	633,080,000	16,600,000
Serial bonds	61,310,000	—	(61,310,000)	—	—
Convertible capital appreciation bonds	—	178,010,000	—	178,010,000	—
Capital appreciation bonds	—	551,790,000	—	551,790,000	—
Less deferred amounts:					
For issuance discounts	(11,560,566)	(22,081,398)	11,908,134	(21,733,830)	(684,868)
Capital appreciation discount	—	(533,472,970)	5,741,791	(527,731,179)	(1,791,889)
On refunding	—	(38,525,615)	895,945	(37,629,670)	—
Total bonds payable	<u>\$ 627,899,434</u>	<u>771,355,017</u>	<u>(623,469,130)</u>	<u>775,785,321</u>	<u>14,123,243</u>
2005	Beginning balance	Additions	Reductions	Ending balance	Due within one year
Term bonds	\$ 579,640,000	—	(1,490,000)	578,150,000	2,050,000
Serial bonds	61,310,000	—	—	61,310,000	—
Less deferred amounts:					
For issuance discounts	(12,402,641)	—	842,075	(11,560,566)	(839,686)
Total bonds payable	<u>\$ 628,547,359</u>	<u>—</u>	<u>(647,925)</u>	<u>627,899,434</u>	<u>1,210,314</u>

# TOBACCO SETTLEMENT AUTHORITY

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## Notes to Financial Statements

June 30, 2006 and 2005

### (4) Debt Defeasance

During the year ended June 30, 2006, the Authority issued \$664,552,153 in revenue bonds with interest rates ranging from 5.375% to 6.50% to advance refund \$639,460,000 of outstanding Tobacco Settlement Asset-Backed Bonds, Series 2001A and 2001B with interest rates ranging from 5.30% to 6.79%. The unamortized discount and deferred charges totaled \$21,733,830 and \$37,629,670, respectively, at June 30, 2006 and 2005.

Net proceeds of \$594,662,216, combined with \$19,715,522 of trapping account and \$52,467,154 of debt service reserve funds totaling \$666,844,892 were placed in an irrevocable escrow trust fund with the Bank of New York as trustee. The escrow fund is sufficient to fully service all remaining principal and interest due on the bonds. The Tobacco Settlement Asset-Backed Bonds, Series 2001A will be paid from escrow on the respective maturity or redemption dates, at the redemption prices (as expressed as percentages of the principal amount of the refunded bonds to be redeemed) as follows:

	<u>Maturity date</u>	<u>Redemption price</u>
Series 2001 A Term Bonds	June 1, 2009	100%
Series 2001 B Term Bonds	June 1, 2011	101
Series 2001 B Term Bonds	June 1, 2010	101

The reacquisition price exceeded the net carrying amount of the old debt by \$38,525,615. This amount has been netted against the new debt and is being amortized over the remaining life of the refunded debt, which is shorter than the life of the new debt. This advance refunding resulted in an increase in aggregate debt service of \$94,938,174 over the next 22 years and an economic loss (difference between present value of the old and new debt service payments) of \$13,779,395 based upon projections of turbo bond redemptions.

The amount of defeased debt outstanding but removed from the statement of net assets (deficit) at June 30, 2006, is \$628,319,277.

### (5) Net Deficit Balance

The payments to be received under the MSA represent a share of anticipated future sales of tobacco products. Although the Authority expects to receive certain amounts under the MSA, the collections are not assured.

Under U.S. generally accepted accounting principles, such contingent amounts cannot be fully recognized as a receivable or revenue. Accordingly, the Authority is reporting a net deficit balance of \$676,078,541 and \$525,093,458 at June 30, 2006 and 2005, respectively.

### (6) Tobacco Litigation Risk

The amount of revenue recognized by the Tobacco Settlement Authority could be adversely impacted by certain third-party litigation involving tobacco companies and others.

**Independent Auditors' Report on Internal Control over Financial Reporting and on  
Compliance and Other Matters Based on an Audit of Financial Statements  
Performed in Accordance with *Government Auditing Standards***

The Board  
Tobacco Settlement Authority:

We have audited the financial statements of the Tobacco Settlement Authority, a component unit of the State of Iowa, as of and for the year ended June 30, 2006, and have issued our report thereon dated January 23, 2007. We conducted our audit in accordance with auditing standards generally accepted in the United States of America, Chapter 11 of the Code of Iowa, and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

**Internal Control Over Financial Reporting**

In planning and performing our audit, we considered the Tobacco Settlement Authority's, a component unit of the State of Iowa, internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

**Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the Tobacco Settlement Authority's, a component unit of the State of Iowa, financial statements are free of material misstatements, we performed tests of its compliance with certain provisions of laws, regulations, contracts, grants, and other matters, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of management of the Tobacco Settlement Authority, a component unit of the State of Iowa, and is not intended to be and should not be used by anyone other than these specified parties.

**KPMG LLP**

January 23, 2007